NEWSLETTER | Q2 2016

RETIREMENT REFORMS: A Bipartisan Success Story

KENNETH A. SIMPLER
STATE TREASURER

INTRODUCTION

In what should come as a surprise to no one, everything in Dover is political. Politics, is, after all, the means for deciding who gets what, when and how.

This is not a cynical assessment, but rather a reminder that politics is the best system we have yet invented for the free people of a Democratic Republic to make collective decisions about their common governance and allocation of public resources.

What I aim to share in this newsletter is my first experience as an elected official with the political process and what I would say were the Four C's that made this particular episode successful: Candor, a Cause, Credibility and Congeniality.

Perhaps like the C's of our Delaware economy (Cars, Credit Cards, Chickens, Chemicals and [health]Care), some of these elements may fade in and out of importance, but collectively prove robust over time. We'll see.

Even if the lessons I took away from this episode prove unique to the circumstances, those circumstances are worth understanding in their own right.

The context is the major overhaul of the State's defined contribution plans. This is an area of great import, as the retiring Baby Boomer population will strain our fragmented system for managing retirement readiness. As a State, we can and should do more to prepare.

DELAWARE'S DEFINED CONTRIBUTION PLAN ARCHITECTURE

Delaware's 35,000 state employees and teachers enjoy significant pension and healthcare benefits in retirement that are guaranteed by the State. In addition, all employees are eligible to receive Social Security from the federal government.

Collectively, these benefits are estimated to provide the average employee with as much as 70% of annual working age income in retirement.

That average belies several assumptions. First and foremost, that the employee remains with the state and that his/her pension is fully vested. Second, that federal entitlement reform does not diminish projected Social Security benefits.

Finally, more recent research into retirement readiness suggests that the old benchmark of having 70% replacement income is not proving satisfactory or even sufficient for many retirees who do not want to "downsize" their standard of living in retirement.

Recognizing that voluntary, supplemental savings are an important means of augmenting employee retirement readiness, the State of Delaware launched a program for state employees akin to a 401(k)-style plan almost twenty years ago.

Soon thereafter, the myriad of retirement plans for state teachers (which varied by school district and numbered over 100 providers) was consolidated to a retinue of 13 vendors under a single state-run "teachers plan."

The two plans — employees and teachers — are legally separate but essentially identical. Employees and teachers direct money from their paychecks into federally tax-advantaged savings accounts sponsored by the State but over which the participant has investment discretion.

The State's plans are overseen by a Board comprised of elected officials, cabinet secretaries, state employees and members of the public appointed by the Governor. The Office of the State Treasurer supports the Board and manages the administration of the plans via a network of record-keepers, investment vendors, compilation firms, accountants and attorneys.

A POOR STATE OF AFFAIRS

When I arrived at the Treasurer's office in January of 2015, the Board had initiated a process to review the overall architecture and administration of both the employees and teachers plans using a third party consultant.

As fiduciaries for the plans, the Board members were rightly concerned that the plans had not undergone meaningful reforms since inception while over the same period the regulatory environment and the retirement industry had changed in substantial ways.

Notably, the sole vendor for the employees plan had not been bid out competitively since the plan's inception in 1999.

Similarly, the investment managers for the teachers plan had not been through such a process since the plan's consolidation in 2009.

In all other areas for which my office manages financial services for the State of Delaware, the norm is to bid out contracts every 3-5 years. The plans were an anomaly.

Moreover, from inside the office, the inefficiencies of the plans' administration were obvious. Staff skilled in financial planning spent most of their days trying to ensure that administrative matters such as file transfers, participant contributions, changes to accounts and permitted withdrawals were handled properly by the network of third party providers.

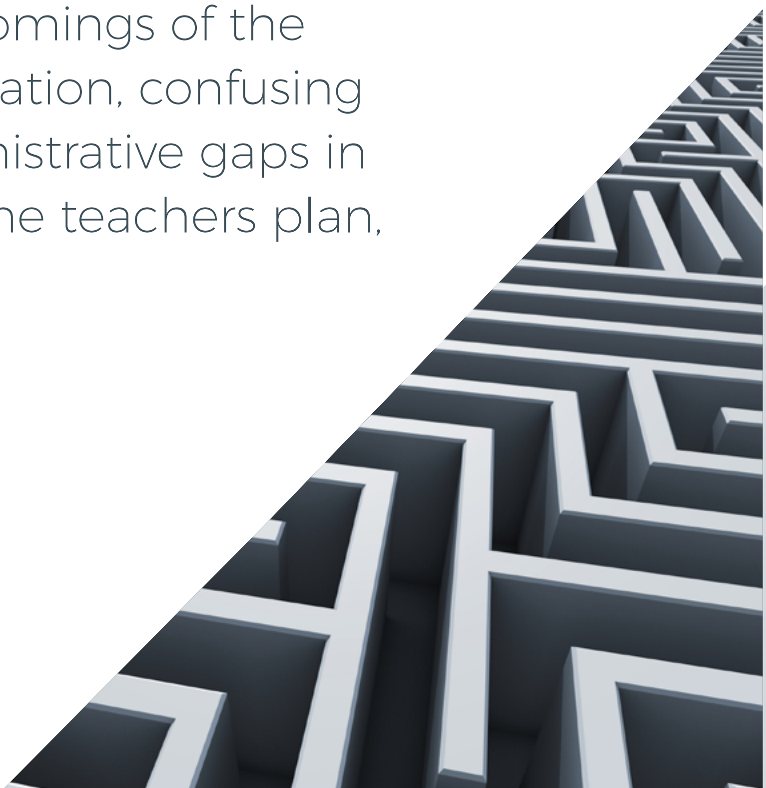
Little to no time was available for strategic outreach or participant education. As a consequence, plan participation rates hovered around 30% with average account balances less than one year's earnings.

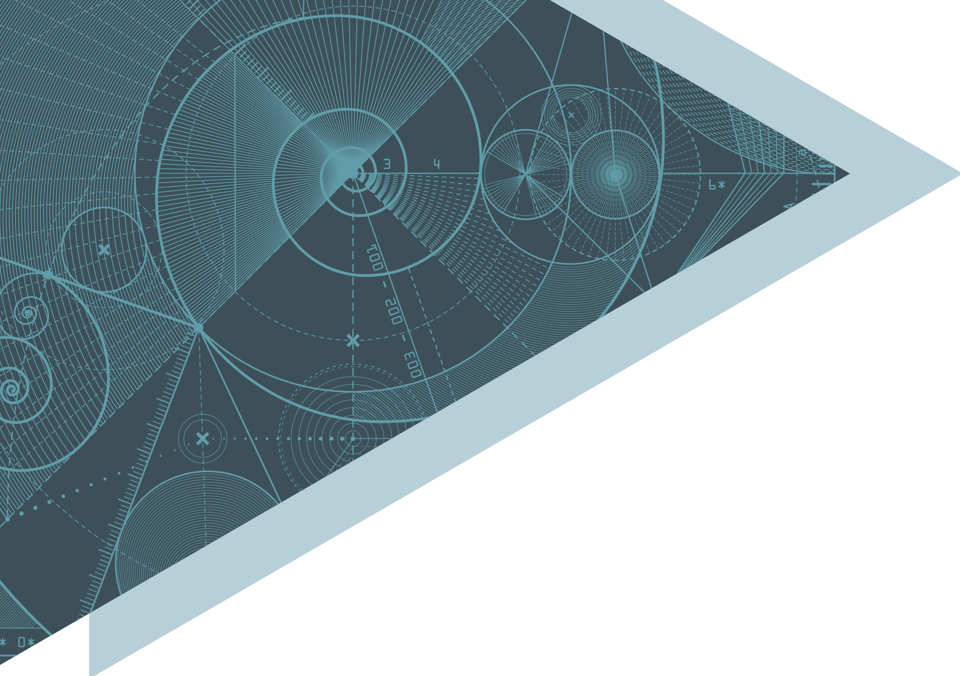
With the engagement of the consultant in the early spring of 2015, there emerged a consensus among Board members that material changes to the plans were in order and that the new architecture had to address the shortcomings of the existing plans: low participation, confusing investment choices, administrative gaps in service and, especially in the teachers plan, unreasonably high costs.

At the overarching level, we determined that the mission statement for the plans was simply deficient. Whereas the State had been focused on simply "offering a benefit" to employees, a new mandate was laid down: "help employees achieve independent retirement readiness."

This strategic shift was not to be fulfilled by investing greater resources, but by a more efficient and thoughtful allocation of existing monies and manpower.

There emerged a consensus among Board members that the new architecture had to address the shortcomings of the existing plans: low participation, confusing investment choices, administrative gaps in service and, especially in the teachers plan, unreasonably high costs.





THE EMPIRICAL PROCESS

After a comprehensive, independent review of the State's plans, the consultant submitted a report to the Board recommending that the employees and teachers plans be consolidated under one vendor and that the core investment choices available to participants be narrowed and differentiated.

In the consultant's opinion, this would lead to several benefits for participants: lower costs, higher participation rates and more robust services.

The report also emphasized the difficulty of this undertaking.

Participants would require education and outreach to understand the benefits of the changes. State IT systems would need to be tested and modified to accommodate the conversion of the plans.

And, most ominously, political opposition from existing plan vendors who would not be part of the future plan structure would be fierce.

Each of these challenges alone would prove substantial. Collectively, they would test the resolve of the Board and my office over the ensuing year.

The consultant's initial conclusions were not adopted outright, but instead were put to close scrutiny by two independent committees, each comprised of members of the Board and my office.

One body led an omnibus request for proposal (RFP) process both to due diligence the plan architecture and to solicit potential vendors for the plans. The other committee reviewed a variety of fund offerings, means of selecting among investment choices, and tiering of investment options.

From design to completion, the two committees conducted a process that took nearly 10 months, involved multiple rounds of vendor interviews and hundreds of man hours of outside study.

The consultant informed the Board that in all its engagements with other states and public entities it had never been part of a more thorough process.

The core recommendations from the two committees were unanimously approved by the Board in May of 2016 and, in general, followed the advice of the consultant:

I. All plans were to be consolidated under a single vendor, that in addition to administrative recordkeeping, would provide four full-time salaried personnel to support participant retirement planning;

II. The funds to be offered under the plans would not be products proprietary to the single vendor, but would instead consist of a fund array independently recommended by the consultant and approved by the Board; and

III. Participants would be offered a tiered menu of fund choices, prominently emphasizing low-cost, age-indexed portfolios with meaningful growth potential and no charges or fees for changing investments or moving their portfolio to another sponsor if separated from the State of Delaware.

Though the Board and my staff were confident that we had done a responsible job and acted throughout the process in the best interests of plan participants, we were regularly reminded that our work was not taking place in a vacuum, but under a microscope.

THE POLITICAL PROCESS

From the time of the consultant's initial recommendations, the Board and my staff held meetings with both the Governor's Office and the General Assembly in order to apprise them of the potential for significant reform of the employees and teachers plans.

Independent of but related to the RFP process, we sought changes to both the Board structure and the organization of my personnel as well as the return of the management of the College Investment Plan to the Treasurer's office from the Department of Education.

Specifically, we proposed consolidating the three boards overseeing plans for retirement investing, college savings and disability planning into a single Plans Management Board.

We also requested a reclassification of positions in my office to allow for the creation of an operating division dedicated exclusively to servicing the plans and supporting the new Board.

In both cases, the changes were designed to focus and harness greater expertise and improve the management of the plans.

Conversations with a great number of legislators ensued on those two parallel tracks. On the one hand, we worked with lead sponsors from both sides of the political aisle in each of the House and the Senate to draft the legislation that would be required to effect the merger of the boards, conform the governance provisions of the plans and place administration of the college plan at the Treasury.

On the other hand, we held meetings with groups of legislators to provide both background on and a roadmap of the RFP process and solicit concerns and advice.

These included members of the education and finance committees, but also Democratic and Republican leaders in each chamber of the General Assembly. While these actions were technically on independent tracks, the issues became politically commingled given outside opposition to the RFP process.

Soon after the announcement of the RFP, letters from organizations representing vendors opposed to the process flooded the Legislature. Concerns were also sent to lawmakers from the union representing state teachers, including a few waves of automated emails directed to specific members by constituents in their districts.

Blogs were developed urging employees to write their legislators and call on my office. The vendors' national organization even hired a prominent local firm to lobby for its members, going so far as to craft legislation to have the General Assembly halt the RFP.

While many of the concerns expressed were valid, a good number were designed simply to slow us down and otherwise cast doubt on the process.

Throughout the RFP we were at a significant disadvantage in terms of communication. The State's procurement rules and the attorneys that advised the Board and my office limited what we could say regarding the plan review lest we compromise the process.

Within these limits, we held meetings with interested legislators and penned general responses to several of the mass mailings sent by our political opponents to the General Assembly.

Ultimately, the year-long odyssey culminated a 30-minute meeting three days before the end of the legislative session. I was called by the Controller General to speak with the heads of the Joint Finance Committee, the legislative body that drafts the annual operating budget.

In that meeting, the co-chairs showed me language that had been prepared as an addendum to the budget's epilogue that would have undone the work of the Board, my office, the consultant and the various state agencies involved in the RFP process — literally months of exertions defeated by a few sentences.

In that small enclave, I was the recently elected Republican State Treasurer and they were two veteran Democratic lawmakers.

While none of us were oblivious to the politics of the situation, the focus of the conversation was on whether the results of the RFP process and the accompanying legislation were in the best interests of plan participants, our state employees and teachers. We all concluded that that they were.

The proposed addendum was not added to the budget bill. Our reforms passed.

SUMMING UP

For a Treasurer in only his second year in office, this was a protracted "teachable moment." As noted at the top, I cannot claim that the lessons of this episode can be applied universally with success, but I would wager that they are worth following.

First, politics involving major reform is a lengthy process, requiring a high level of engagement with multiple stakeholders.

Frequent and candid communication of a straightforward message is therefore critical. In this case, the simple truth was that our plan architecture was dated, costly and failing — our employees and teachers were not achieving retirement readiness. The devil was, of course, in the details, but this was the honest headline with which we stuck throughout the process.

Second, politics favors being on the "right" side of the issue. As any political decision produces winners and losers, this may simply boil down to being on the side where the winners outnumber the losers, but it is still best to have your side believe in the justness of their cause.

Our Board and our office were not zealots or partisan warriors in this instance. Rather, we were fiduciaries for state employees and teachers and we took that obligation to heart.

The changes we made were effected solely in the best interests of our participants. These facts created cohesion and a commitment to seeing our cause to the end, win or lose.

Third, the political process does not ignore evidence and empiricism. Though every side to a political contest will marshal its own facts, the more credible group has an advantage.

The hundreds of man-hours poured into researching plans across the country, studying behavioral finance theory, interviewing our network of vendors and working with one of the top consultants in the industry paid off.

Conversely, the "facts" and attacks asserted by our political opponents were not rigorously evidence-based. Many were hollow and shrill assertions that did not hold up to close scrutiny. We had done our homework with an open mind to our opponents' positions. They had not; advantage us.

Last, and this one may be the most important of all, politics should not be confused with partisanship. While all issues of governance are political, not all political issues are divided along party lines.

In this case, I had to confront some fairly angry legislators from both sides of the aisle. But I also received support from key Democrats and Republicans. In both cases, being congenial within and across party boundaries was a positive.

Politics is ultimately about resolving Conflict and Confrontation; but, it can and should be done Constructively and Civilly. Candor, a just Cause, Credibility and Congeniality matter.

I know that's a lot of C's, but if they work for our Delaware economy why not our state politics?

Yours,

Ken

Ken Simpler, Delaware State Treasurer

EPILOGUE

For those of you who will allow me a few more lines, I want to make a couple of points about the context of this epistle.

Retirement readiness is a topic with which we are all going to becoming more familiar with as the number of retiring Baby Boomers continues to peak.

Will they be prepared? Will Social Security and Medicare remain solvent and provide a floor to other individual savings and benefits? What will be the impact here in an aging Delaware?

As State Treasurer, I have no role in reforming Social Security, Medicare or any of our other federal programs that provide a safety net and dignified retirement for our seniors. I need to hope that federal lawmakers get it right on those issues as the long foreseen "gray wave" is here.

I also have no formal role in helping Delawareans outside the public sector prepare for retirement.

Many state treasurers across the country have launched financial literacy campaigns with the goal of making the general population more fiscally responsible.

Personally, I am dubious about the impact of these models as my experience tells me that most adults planning for retirement really want to understand their own particular financial situation, not be educated on general finance theory.

In my opinion, the latter is best done in K-12 education, but that is not going to address the current flood of retirees.

At the state level I do not even have a seat at the Pension Board, the body that manages the State's defined benefits plans. At roughly $9 billion in assets, these plans are substantially larger than the $1 billion that employees and teachers have amassed in the defined contribution plans that I do oversee.

The logic on having these plans managed by separate state agencies, the Office of Management and Budget and the State Treasurer's Office, respectively, is not obvious to me — particularly when the Treasurer's Office used to manage both.

In my present role, I do have the authority to implement the meaningful reforms that we have achieved in the narrower but significant area of employee voluntary retirement.

The complete overhaul of these plans to world class platforms for supplemental savings is something that I can now confidently promote to the 35,000 state employees and teachers whose immediate families make up as much as 10% of our State's population. That's a start.

The reforms to these plans and their administration are also a place from which to learn about ideas that may be scalable within and outside state government.

Looking at returns earned in the pension fund and by individual investors could be instructive. Offering employees the option to allocate more funds from a collective pension plan to their own savings plan may be worth exploring.

At a minimum, funding levels, the character of long term assets in plans and the pros and cons to both participants and taxpayers of all possible means to achieve retirement readiness should be examined objectively and thoroughly. It's time to make certain were on top of this wave before it crests.

Read Ken's newsletters online or sign up to receive them via email at treasurer.delaware.gov.

Blueprint for a Bargain: Let's Listen and Act

Bipartisan Budget Accord: Framing a Grand Bargain

Creating a Performance-Driven Culture: A New Order of Things

Retirement Reforms: A Bipartisan Success Story

Caring About the State's Healthcare Plan

A Whole Lot of Alliteration: Spending Sustainability, Sufficiency and Soundness

Who Doesn't Want a Good Value?

The Budget Trifecta: Revenue Stability, Spending Discipline and Value Creation

First (and Lasting) Impressions: My First 100 Days

Consider inviting Ken to address these topics at your organization's next meeting or event.

Please contact us to schedule:

phone (302) 672-6700
email statetreasurer@state.de.us
web treasurer.delaware.gov/invite-treasurer/

KENNETH A. SIMPLER
STATE TREASURER